

It seems in retrospect that 2005 was the year of the mega-deal, and private equity firms can take credit for being behind much of that action. According to *CFO Magazine*, in 2005, 11 North American companies were purchased at prices that

topped \$10 billion (€7.8 billion) per deal, as aggregate deal value for the year rose to \$839 billion.

Not since 2000, when a roaring US equity market fueled by the five-year Internet boom sparked unforeseen levels of merger and acquisition activity, has the market been so hot. At that time, and similarly in 2005, private equity was instrumental. But the 2005 version of the groundswell activity occurred under different circumstances. Capital is key, and in today's private equity landscape, it's present in abundance. With jumbo funds seeking involvement in nearly every major corporate finance transaction, boosted by low interest rates and eager lenders, private equity funds participated in some of the year's biggest deals, capturing 18 out of the top 100 M&A deals of 2005 valued at greater than \$1 billion.

The world of private equity has experienced changes across the board. Increases in fund and deal sizes, the global reach of investment strategies across geographies, and the generational shift within long-standing private equity giants, have all contributed to the increased complexity of managing and administering today's private equity programs.

Private equity firms and institutional investors alike recognize that the industry's growth has translated into formidable administrative challenges. As a result, more players in the industry are relying on third parties to provide a multi-faceted solution for supporting the management of the private equity programs beyond doing deals. While the number of US firms currently serviced by third-party administrators or private equity outsourcers is estimated by some industry experts to be roughly 10 to 15 percent (and slightly higher in Europe), the benefits of outsourcing - as evidenced by its prominent role in the hedge fund industry - suggest that this percentage will grow.

THE CHALLENGES OF A HOT MARKET

As the private equity industry enjoys unprecedented growth and increased prominence as an asset class in most portfolios, a growing number of private equity firms and institutional investors are learning that outsourcing administration and operations may be a significant success factor. Al Foreman, strategy executive at JPMorgan Private Equity Fund Services, explains why.

WHY OUTSOURCE?

Whether due to tradition or lack of good resources, handling back office functions internally was perceived by most as the only option for sophisticated private equity firms. But as private equity firms have grown in number, complexity, and reputation, they have realized that effectively running private equity operations requires significant internal resource to properly provide risk management, efficient operations and consistency. Often these requirements place heavy burdens on private equity firms and institutional investors.

The message is beginning to ring clear to all - outsourcing to firms that have established tenures and exposure to similar administrative challenges places the burden of dealing with the intricacies and complexity of private equity administration on experts. These outsourced administrators who have already garnered a track record in dealing with an assortment of private equity vehicles, firms and jurisdictions provide the type of support that could take decades to replicate internally.

One must combine the challenges related to the growth of the industry with the needs of the people providing the capital (institutional investors) to paint a true picture of the current private equity landscape. Savvy investors are now demanding that even the smallest private equity players provide best-in-class reporting, consistent disclosure on investments, solid-state monitoring procedures and transparent remuneration structures.

These demands have caused a shift in terms of where the time and resources for private equity firms need to be focused. Given the competitive landscape, managers are finding that generating returns that will bring investors back for successor funds requires devoting more attention to their core competencies of selecting and managing good investments. Faced with this challenge, there has been a movement toward allowing third-parties to take on the burden of certain essential, but non-core duties, such as fund accounting and administration.

WHERE'S THE TALENT?

Without question, the teams of individuals who service institutional limited partner portfolios or private equity fund families represent one of the most important elements of the administrative and operations equation. Yet this function is a highly specialized one, and the talent required to perform these functions is tough to secure. The supply of qualified private equity accountants does not meet the demand due to the record levels of new capital pouring into the industry, and the number of new spin-off firms that require this talent. Additionally, the far-reaching industry group reporting and valuation guidelines, and the increased pressure from limited partners for transparency of all facets of a fund's operations and policies, has made it extremely difficult for private equity firms to hire enough fund accountants with the requisite experience.

With no broad training ground for new talent, and with most of the qualified people already working in private equity firms, there are few centralized places to find talent. Even if a private equity firm is capable of finding the people, the implicit costs of attracting, training and retaining that talent is frequently underestimated even by the most seasoned firms. The costboth economic and time - for the oversight of talent is a formidable drain on core focus and resources. This obstacle applies to both new and established firms attempting to maintain an existing capability in-house. These challenges emphasize the role of, and need for, the outsourced service provider.

PRIVATE EQUITY: AN EVOLVING INDUSTRY

It is called private equity for a reason, i.e., firms prefer to do things their own way. This industry characteristic drives the lack of standardization, thus presenting additional obstacles. Since many new private equity firms are formed when a handful of investment professionals spin off from their previous firm and launch a new fund, the level of expertise across the front to back office can vary dramatically. Most importantly, if the founding principals were not previously focused on finance and accounting processes and procedures, they may lack the knowledge required to properly establish the internal infrastructure of their new venture.

The lack of comprehensive industry standards for administration or reporting further supports outsourcing as an optimal solution. With an outsourcing arrangement, a client can dictate specific requirements based on its own preferences, while relying on the third-party expert's deeper and broader expertise regarding industry-wide trends and requirements in administration and reporting.

In November 2005, JPMorgan Private Equity Fund Services (JPMorgan PEFS) was launched. This business stems from the finance and accounting arm of a highly experienced and established private equity player, J.P. Morgan Partners, which operated for more than 20 years. Through its full suite of high-quality, outsourced private equity administration services, JPMorgan PEFS is positioning itself as one of the few fully integrated sources of fund administration and banking services in the market-place today.

In my opinion, there have been two common themes underscoring the private equity industry over the last five years: the need for greater transparency, which can be addressed through superior technological capabilities, and globalization. Today's environment demands that a fund's administrator possesses a global presence and reach adequate to support fund operations anywhere, a capability that surpasses mere bulk and size.

As private equity firms lure more capital, the growth opportunities the industry faces present formidable administrative challenges to both private equity firms and institutional investors. While the amount of dry powder in the market is massive, rising interest rates and cyclical pressures could curb the lending momentum that has been such a boon to private equity buyers in recent years.

We cannot forecast future trends, but as the private equity industry matures and becomes more complex, focused and yet diversified, we can expect a strong likelihood of the need for greater transparency and standardization in our industry. Whatever the outcome, it appears that the need for expert and sophisticated handling of administration is paramount. It could mean more than success in the ever-lucrative private equity space it could mean survival. And survival is often only achievable with the right partner.

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